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EFRAG Research on Equity Instruments – Measurement

Definition of long-term investing

Objective

- 1 The second request for technical advice from the European Commission asks EFRAG to consider alternative measurement bases for equity and equity-type instruments. Some claim that the requirements in IFRS 9 for equity instruments may discourage long-term investing in equity instruments while others claim that the requirements allow to properly depict the performance of long-term investing.
- 2 The objective of this paper is to discuss possible ways to define long-term investing. At this stage, the EFRAG Secretariat has not assessed what implications the different definitions would have in the choice of an alternative measurement basis.

Background

- 3 In the prior Research project on Equity Instruments – Impairment and Recycling, EFRAG TEG and the constituents have generally not supported attempts to define long-term investing or similar notions, both on conceptual grounds and concerns that any definition would be challenging to apply in practice.
- 4 However, the EFRAG Secretariat is still persuaded that an attempt should be made. The IASB has acknowledged that IFRS 9's equity-FVOCI election was intended primarily for a specific sub-set of strategic investments. While it appears that the notions of *strategic* and *long-term* are not the same this shows that there are arguments to consider different treatments for different sub-sets.
- 5 The EFRAG Secretariat notes that IFRS 9 *Financial Instruments* sets specific requirements for equity instruments that are held for trading and are not eligible for the equity-FVOCI election. Held for trading is defined as an instrument that is:
 - (a) Acquired or incurred principally for the purpose of selling or repurchasing in the near term;
 - (b) On initial recognition, is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - (c) A derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

How can a definition of long-term investing be helpful?

- 6 The European Commission has not asked explicitly EFRAG to define long-term investing, but the EFRAG Secretariat believes that a working definition may nonetheless prove helpful in developing an acceptable advice.

- 7 It is clear that there are mixed views on the appropriate accounting for equity instruments. For example, some believe that the different characteristics of debt and equity instruments (presence or absence of contractually-specified cash flows, other rights, legal protection, treatment in bankruptcy, volatility and exposure to risk) require a different accounting treatment. Others believe that investors manage portfolios with different classes of assets, and that when debt and equity instruments are part of portfolios managed together their treatment should reflect this.
- 8 The EFRAG Secretariat believes that these two views are unreconcilable and therefore proposing changes to the accounting requirements for all equity instruments (such as the reintroduction of recycling or the use of a historical cost basis) would not find consensus. Restricting any recommended changes to IFRS 9 to a sub-set of equity instruments has the potential to be more acceptable to a larger group of constituents. It is also more fitting to the nature of the request from the European Commission, whose objective is to ensure financing of specific investments.
- 9 However, we acknowledge that as usual there is a trade-off between relevance and comparability. No proposed definition will achieve both characteristics in full.
- 10 The EFRAG Secretariat has also considered if an argument could be made that all instruments that are not held for trading are long-term investments. However, we do not think this is the case. We understand that an investment is held for trading when the investor is ready to sell it at any moment, based on the market conditions. The EFRAG Secretariat considers that long-term investing should imply that at acquisition the holder has the intention to maintain the investment for a substantive period of time. There is room for an intermediate class of investments where the investment is initially held with an undetermined purpose.
- 11 On the other side, it should be noted that introducing different accounting requirements for long-term investing, however defined, will give rise to questions about whether an instrument could/should be reclassified or transferred within portfolios (unless the criterion applied at an entity-wide level) if the specified criteria cease to be met or are newly-met.

What can the definition be?

- 12 Initial candidates as defining criteria that are analysed in this paper are:
 - (a) The characteristics/ business model of the investor – this would tie-in to the notion of long-term investor;
 - (b) The expected or actual holding period – this would tie-in to the notion of long-term investment (rather than investor);
 - (c) The long-term nature of the (underlying) liabilities.
- 13 For the discussion at this meeting, we suggest that EFRAG TEG considers the criteria individually. It would however be possible to use more than one either in combination or as alternatives.
- 14 A potential alternative could be to consider the nature of the activities of the investee. This would tie-in to the notion on investment in infrastructure (rather than long-term or short-term investments). The EFRAG Secretariat notes that this would require a comprehensive taxonomy of all economic activities. Based on an initial exchange of views with the EC staff, this does not seem achievable in the timeline of the project. Also, it would require that the IASB accepts using the taxonomy as a basis to amend its requirements, which (regardless of the source) would be unlikely.

The characteristics/ business model of the investor

- 15 The EC in its *Green Paper Long-term financing of the European Economy* issued in 2013 described the capacity of financial institutions to channel *long-term finance as a business model* in its investment portfolio.
- 16 The EC paper also described the financing process right as a central issue to support structural economic reform and the return to the long-run trend of economic growth. Long-term financing was also needed throughout the whole lifecycle of a company, helping to start a business, allowing it to grow and then sustaining its growth. Long-term financing would support the transition of companies as they progress through this life cycle.
- 17 In July 2015, EFRAG issued a Bulletin *Profit or loss versus OCI*, which identified four groups of business models, one of which was the *long-term investment business model*. The business models used, for example, by banks and insurance entities would generally belong to this group, although banks may also undertake short-term trading activities.
- 18 In a long-term investment business model, entities acquire assets in order to generate a stream of revenue from period to period. Nevertheless, the ultimate cash inflow from the asset is often through sale in the market in which it was originally bought and, generally, in a similar 'condition' as when it was bought. Cash flows are generated by holding the asset (e.g. in the form of dividends, or income from letting others use the asset) and from sale of assets. Those sales are critical events as disinvestment decisions are significant from a stewardship perspective.
- 19 The IASB has also used the concept of *business model* in IFRS 9 as one of the criteria relevant to the classification and measurement of financial assets:
 - (a) [B4.1.1] *Paragraph 4.1.1(a) requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets, unless paragraph 4.1.5 applies. An entity assesses whether its financial assets meet the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a) on the basis of the business model as determined by the entity's key management personnel (as defined in IAS 24 Related Party Disclosures);*
 - (b) [B4.1.2A] *An entity's business model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. [...]. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information;*
 - (c) [B4.1.2B] *An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment.*

- 20 However, the IASBs articulation of the 'hold to collect' business model is inextricably linked to the characteristics of the underlying assets, since it refers to *an objective to hold financial assets in order to collect contractual cash flows*. This objective is not applicable to an equity instrument, which does not entitle the holder to any cash flow.
- 21 The EFRAG Secretariat acknowledges that from a relevance stand point a differentiation based on the nature of the business model is preferable. Several frameworks have been proposed to categorise business models and could be used to refine the content of the EC paper and EFRAG bulletin mentioned in paragraphs 15 and 16 above.
- 22 However, the EFRAG Secretariat is also aware that a differentiation based on the nature of the business model would be inherently judgmental, especially for complex entities. As noted above, a question would arise on whether the assessment of the business model should be carried out at entity-wide level, at segment level or lower. If it was accepted that entities have different business models, then the question would arise on if and how transfers should be addressed.

The expected or actual holding period

- 23 The expected or actual holding period would be more practical than a qualitative definition if it was defined using a numerical threshold. That would enhance comparability among companies when they categorise their investment portfolios.
- 24 Using the expected holding period means that entities would assess and classify equity instruments as long-term investments at inception. Using the actual holding period means that an instrument would be transferred to the long-term category only after the entity has held for a defined period of time.
- 25 Beyond the potential arbitrariness of a numerical threshold, a differentiation based on this criterion would introduce a number of operational issues that should be further assessed:
- (a) If it is based on the expected holding period, would there be implications arising from a sale occurring before the period ended? Investors claim that although they have a long-term perspective, they need to re-balance their portfolios. If there were no implications, then the classification would become substantially a free choice. To limit this, a tainting provision could be introduced, but this would require to:
 - (i) Define if any level of sales would activate the tainting provision; and
 - (ii) Define if the tainting applies to only the instruments sold or to the whole long-term portfolio.
 - (b) If based on the actual holding period, it could result in the counterintuitive outcome that an investment expected to be disposed of shortly after acquisition may be treated as a long-term investment, assuming that the requirements are compulsory and not optional.

The long-term nature of the (underlying) liabilities

- 26 Some IFRS Standards allow the use of accounting mechanisms to reflect a linkage between assets and liabilities. Paragraph 6.58 of the *Conceptual Framework for Financial Reporting* recognises that, in some circumstances, when assets and liabilities are related in some way, using the same measurement basis for the related assets and liabilities contributes to the usefulness of information.

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- 27 Examples are the presentation of the return on qualifying assets held in a defined benefit plan in IAS 19 *Employee Benefits*, and the presentation of financial income/expenses in IFRS 17 *Insurance Contracts* for contracts with direct participation features, when the entity holds the underlying assets.
- 28 During the project on Equity Instruments – Impairment and Recycling, some constituents claimed that equities may be held with the view to meeting obligations under long-term liabilities, and this linkage should be reflected in the way the investments are accounted for. The EFRAG Secretariat understands that this claim refers mostly to the depiction of performance in profit or loss.
- 29 For instance, insurance companies invest in equities and other assets to generate cash inflows used to settle their insurance liabilities. Energy companies may invest in equities to generate cash inflows to settle their obligations in relation to decommissioning of nuclear plants.
- 30 This differentiation criterion would naturally point out to an accounting solution that, to the extent possible, reflects the expected match between assets and liabilities over a suitable long-term horizon. Accounting mechanisms that achieve this objective could be:
- (a) An allocation mechanism that attributes part of the fair value change of the equity instruments in profit or loss and part in Other Comprehensive Income;
 - (b) An adjusted fair value measurement basis that only incorporates the same elements that affect the measurement of the linked liability. For instance, if the liability is measured at amortised cost using the effective interest rate at inception, the adjusted fair value would exclude the effect of the changes in interest rates.
- 31 However, a differentiation based on this criterion gives rise to a number of conceptual and operational challenges. Firstly, there would be a need to determine if simply carrying long-term liabilities would be sufficient to qualify for long-term investing, or a more stringent relation is needed. For instance, would there be a need for a legal obligation to hold assets? Should there be an economic relationship between the equity investments and the liabilities, such as the amounts of their cash flows be affected by changes in the same market factors, or inverse correlation in their values?
- 32 Secondly, and subject to the above, the range of qualifying liabilities could include items that are measured differently (amortised cost, fulfilment cost, best estimate of the settlement amount). In that case, the accounting mechanism would need to be articulated differently based on the measurement feature of the liability, or the measurement of the qualifying liabilities would have to be modified.
- 33 The EFRAG Secretariat also notes that investors may hold diversified portfolios to back up long-term liabilities. If the liabilities were linked to a portfolio that included both debt and equity instruments, the entity would either need to separate different components of the portfolio – which may be inconsistent with the way the risk is managed; or apply a common measurement to the whole portfolio. If this measurement was other than amortised cost, this would be a significant change.

Questions for EFRAG TEG

- 34 Would EFRAG TEG suggests further work on the definition of long-term investing, with the purpose of using it as a basis to develop an alternative measurement basis?
- 35 Which of the three criteria mentioned in the paper would you advise to focus on? Do you propose other criteria for consideration?